DOW THEORY LETTERS INC.

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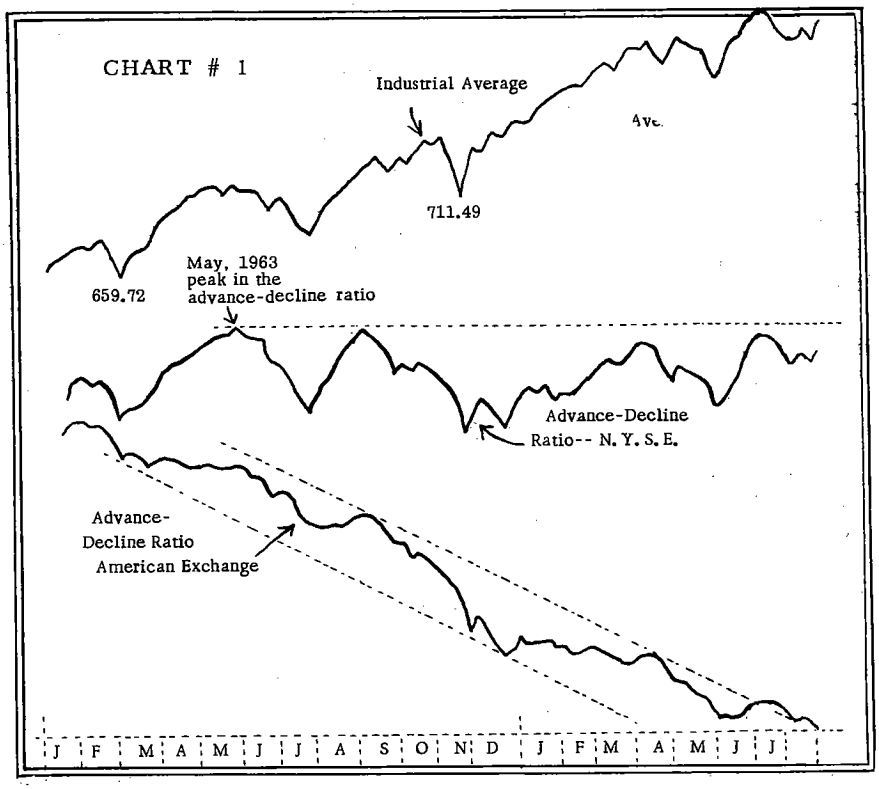
THE MARKET: Following the last joint highs, which were recorded by the D-J Industrial and Rail Averages on July 17 (Chart 2), the two indicators broke to lows on August 6. A dull rally lifted the Averages again, but on August 18 the Rails sank below their August 6 level. Referring to this action in Letter 263 I wrote: "The Rail penetration of the August low serves to transfer all our attention to the Industrial Average. The question now is -- will Industrials confirm the Rail weakness by violating their own August low (823.40) or will Industrials persistently refuse to confirm the Rail weakness? From the standpoint of market history, it should be remembered that many important advances have materialized from areas where one Average persistently refused to confirm a penetration of the other."

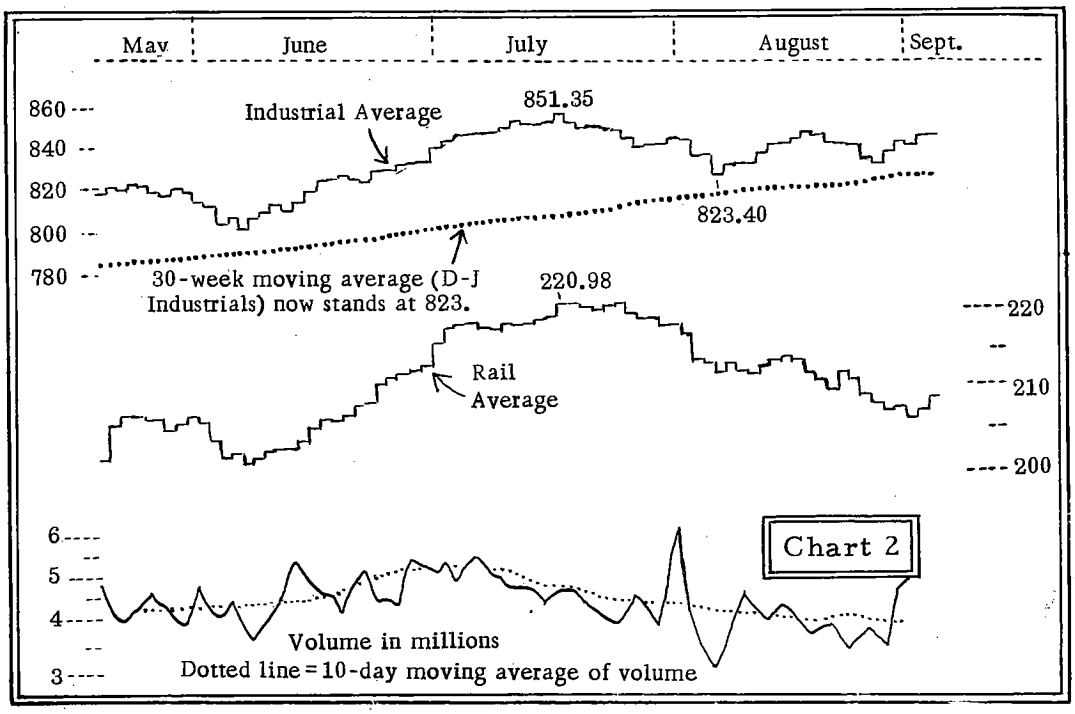


During the 9 trading days following the Rail penetration of their August low, volume contracted drastically while the Rail Average continued its steady decline. Despite the Rail weakness, the Industrial Average stubbornly refused to violate its 823.40 low. On August 27 the senior Average parted company with the carriers and began rallying.

On September 1 and 2 the rally gathered volume (volume on those two days represented the first impressive upside volume since early July). It is worth noting that the current advance finds Industrials considerably stronger than the (lagging) Rails, and this is a situation which has not been seen since November, 1963. In the event of a new all-time Industrial high (above 851.35) it will be most important to see whether Rails confirm by bettering their own all-time high of 220.98.

* * * * *

The August decline took Industrials within 6 points (Chart 2) of their long-term or 30-week moving average (M. A.). In Letter 262 I directed attention to the importance of the M. A. as a gauge of forthcoming market strength or weakness. The fact that Industrials have again refused to penetrate the M. A. (which now stands at 823) is a definite plus in the technical position of the market.



Less promising is the long-term picture as seen on Chart 1. This chart traces the advancing or declining trend of the majority of stocks on the N. Y. S. E. through the mechanism of the advance-decline ratio. In July the A-D ratio turned down for the fourth time since May, 1963, thereby tracing out the longest horizontal range in breadth since 1955-57 (see later section of this Letter). Even less encouraging than this action is the performance on the speculative American Exchange — where the A-D ratio struck a fresh new 1964 low last week. If you are optimistic you can label the Amex performance a picture of "fading speculative interest." If you are bearish you can insist that the Amex is in the throes of a major and continuing bear market.

NOTE: The semi-logarithmic scale in Chart 2 has been changed with this Letter to reflect more movement. This simply means that a larger sized graph paper has been used — but it is still exact semi-log scale dealing in percentages.

PERSPECTIVE: Investing or trading is simplest and most profitable when the Averages and the broad trend of the majority of issues (as measured by the advance-decline ratio) are rising. If the Averages continue to advance (even though the A-D ratio is moving sideways) it is still possible to make money through brilliant stock selection. But such procedure is never easy, and the reason is that when the A-D ratio is traveling sideways, as many stocks are moving up as down. Finally, when the trend of the Averages or the trend of the A-D ratio or both is down it is almost impossible to make money. At such times the market is usually going through a secondary reaction or a bear market phase, and the stockholder is in the unfortunate position of "trying to go up on a 'down escalator'."

As seen on Chart 4, there have been four broad advances since 1953, each one ending in a horizontal trading range for the A-D ratio (against a continuation of the advance in the Industrial Average). The really profitable part of each rise was that part which was characterized by an "in gear" advance in both the Averages and the A-D ratio. The period in which the A-D ratio formed its horizontal range constituted the difficult part for investors. And the ultimate decline from the horizontal range in the A-D ratio was the "disaster period" as far as stockholders were concerned.

In 1956 the A-D ratio recorded its peak in March. The final (famous) "triple top" was struck by Industrials 16 months later — in July, 1957. This was followed by a 100 point Industrial drop.

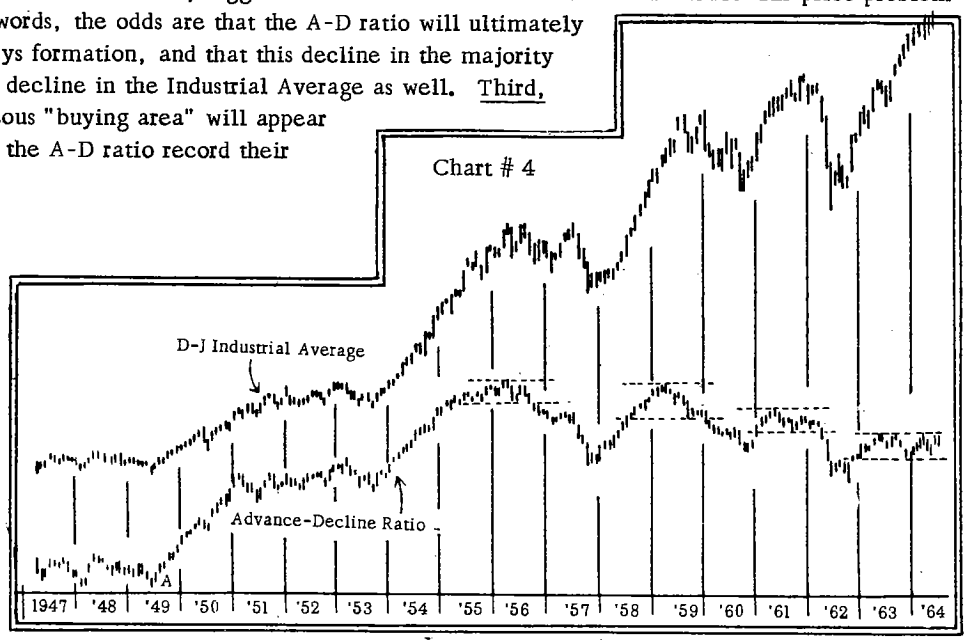
The 1959 peak for the A-D ratio was struck in March, while the ultimate peak in Industrial was established in January, 1960 — 10 months later. A 119 point Industrial decline followed.

The 1961 high for the A-D ratio occurred in May, although Industrials did not record their final peak until December — 7 months later. This was followed by a 199 point drop in Industrials.

The latest rise which began in 1962 saw the A-D ratio strike its peak in May, 1963. And despite a steady rise in the Averages to new all-time highs, 15 months have now elapsed with the A-D ratio still locked in its 1963-64 trading range. (See Chart 4)

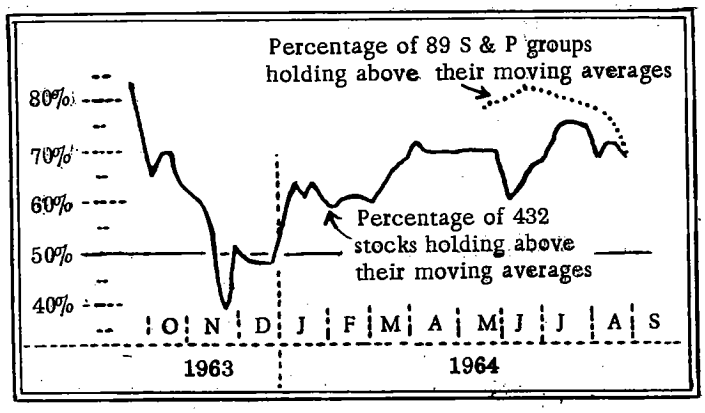
What can we infer at this point? First, we know that since June, 1963, the market has been in an area (characterized by a horizontal trend in the A-D ratio) in which extreme selectivity has been the order of the day. Probabilities suggest that of every 10 stocks purchased since June, 1963, 5 have rallied and 5 have declined. Second, we can state that the odds (based on three preceding horizontal trading ranges in the A-D ratio) suggest that the final resolution of the current breadth-price problem will again be on the downside. In other words, the odds are that the A-D ratio will ultimately break below the lower limits of its sideways formation, and that this decline in the majority of issues will be accompanied by a major decline in the Industrial Average as well. Third, we can say that the next really advantageous "buying area" will appear from wherever the Industrial Average and the A-D ratio record their final lows.

Chart # 4



STOCKS: Of 432 representative stocks tabulated here each week, 295 (68%) are now holding above their 200-day M. A. 's, a drop of 3% since last week (however, the study remains bullish as long as the percentage holds above 50%). Of 89 Standard & Poor Stock Groups (see same Chart on Page 3), 68% are holding above their 200-day M. A. 's, a drop of 9% since the last reading two weeks ago. The market remains a very

hard place in which to make money; for this reason, I have included the following rather elaborate section.


Percentage of 89 S & P groups holding above their moving averages
80%
70%
60%
50%
40%
Percentage of 432 stocks holding above their moving averages
O N D J F M A M J J A S
1963
1964

* * * * * *

Many subscribers have written to ask how I pick stocks for recommendation in these Letters. The answer is that I follow my own rather complicated qualification list. By constantly examining hundreds of individual issues (while keeping the qualification list always in mind), I am often able to come up with a few stocks which will perform well (provided, of course, that the general market is also in a reasonably bullish phase).

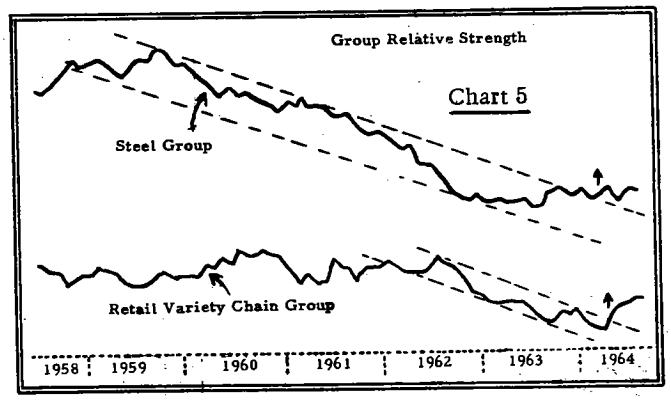
This is the way the qualification list works:
(1) I start with group relative strength (R. S.). If a group, particularly a group which has already suffered a long decline in market popularity, shows signs of a reversal to the upside in its R. S. line, it is obvious that "something interesting is happening here."

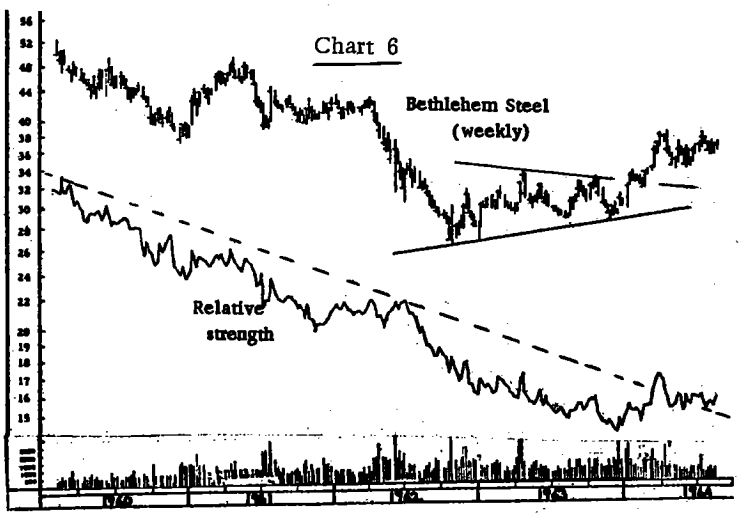
(2) The individual stocks which make up the group are then examined from the standpoint of fundamentals and R. S. I also examine these stocks for signs of significant upside reversal patterns (such as ascending triangles, rounding bottoms, reverse head-and-shoulders formations, etc.). A group which has begun to perform better than the market (i. e., favorable R. S.) will always produce at least one stock which is displaying improving fundamentals, is in a favorable pattern, has an R. S. line which is turning up and in general possesses a "look" about it which suggests that "it wants to go up."

(3) Assuming that I have found one or two stocks in the group which check-out on the above criteria, I then apply two additional gauges. First, I require the stock to be moving on the bullish side of a point & figure trendline. (P & F charts show concentrated action and often reduce many complicated or meaningless movements to easily analyzable patterns). It is well to remember that if a stock is breaking out below a bearish trendline, there is always the possibility that the move is merely a correction within a primary downtrend — rather than a fresh breakout within a primary uptrend. A second check: the stock should be moving above its 10-week (short-term) moving average (M. A.), and the 10-week M. A. should in turn be in a position above the 200-day (long-term) M. A. This three-way relationship is bullish and (by definition) must always precede a major rise in a stock.

(4) Finally, it is a large plus if "insider" buying or fund buying (preferably both) is occurring in the selected stock. If insiders and funds are buying, there will probably be a good following and good sponsorship behind the stock.

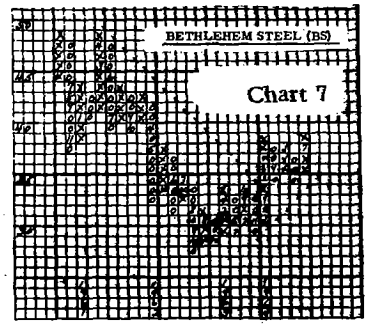
Following are two stocks which I am going to use as both recommendations and as illustrations of the foregoing procedure. Note on the Group R. S. chart (Chart 5) that Steels are now in the process of turning up after a major five year decline. Retail Variety Chains are also reversing a declining R. S. trend which has been in effect since 1962. In other words, interest is coming into these two depressed groups.

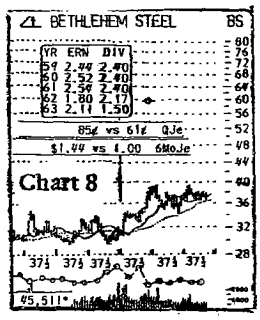




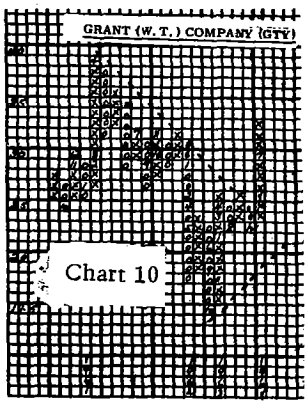
In the Steel Group, Bethlehem is now reversing a decline in R.S. (Chart 6) which began in 1959. Note also that the stock is pushing out of a large symmetrical triangle. On the point & figure chart (7) we see that BS has reversed its major bearish trendline and is now breaking out of a base that measures 16 boxes across. This constitutes a very large base and allows for a substantial upward move (the upward P & F "count" is 48). On Chart 8 we see that BS is holding above a rising 10-week M. A., and the

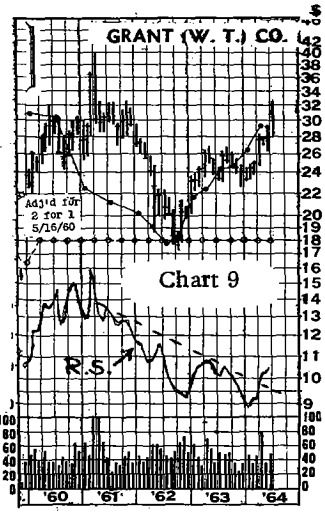
shorter 10-week M.A. is holding above a rising 200-day M. A. (200-day M. A. appears as dotted line on Chart 8, 10-week M. A. as solid line). Finally, statistics show that funds bought 169 thousand shares of BS on balance during the latest period. Conclusion: BS should do better than the market from here on. It is a stock which checks out in all directions.





W. T. Grant was recommended in Letter 259 at 31 1/2. GTY has reversed an R. S. line (see monthly chart 9) which has been in effect since 1961. On the P & F chart (10) we see that GTY has reversed its long term bearish trendline and in rising to the 33 area it has pushed above its late 1961 resistance. The position of GTY and its two M. A. 's (Chart 11) is bullish (all lines rising). Earnings for GTY are strongly up ($1. 95 vs. $1. 49 for the latest 12 months ending in April), and there has been a good bit of institutional buying in this issue. Conclusion: GTY has acted extremely well, and it is again recommended.





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The need for careful research and extreme selectivity in this market is illustrated by the famous "growth" stock MMM (I could have used IBM). MMM has done what in my opinion is the most bearish thing a stock can do. It formed a huge top in 1960-61, broke down, then rallied and formed a second top below the first. The second top has now broken. Note on large chart that MMM's R. S. line has also crumbled. The P & F chart of MMM shows the stock breaking down below the last rising trendline. On the small weekly chart we see MMM in a bearish position below its two M. A. 's and the two M. A. 's are also now declining. Evidently MMM has recorded a major bull market top, and the market is saying that there is something fundamentally "wrong" in this well-known company. Conclusion: MMM can be shorted and carried as a "hedge" against a general decline, particularly in accounts which hold "long" positions in other stronger stocks.

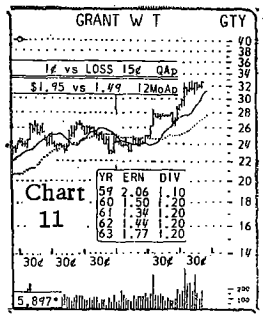

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Chart 6 and large chart of MMM courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.
Chart 5 courtesy Ray * Signals, 141 Broadway, N.Y.C. 6.
P. & F charts courtesy Chartcraft, Larchmont, N.Y.
All small weekly charts with moving averages courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.
Chart 9 courtesy of Security Research, 211 Congress St., Boston, Mass. 02110.